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Building Healthy Capital Markets: From the 2008 Financial Crisis to Digital Disruption and Beyond

by Kara M. Stein

Speech

Thank you Jacques [de Larosière] for the warm welcome. It is an honor and a pleasure to be here at the Eurofi Financial Forum. This regular gathering is a testament to how a robust exchange of ideas can play an important role in strengthening our financial systems and economies. Before I continue, I am required to note that these views are my own and do not necessarily represent those of the U.S. Securities and Exchange Commission (SEC or Commission), my fellow Commissioners, or the staff.

Europe is engaged in a vibrant conversation on what it means to build a “capital markets union.” It was suggested to me that I might want to speak tonight on lessons that the United States has learned in building our version of a “capital markets union.” This is a big topic – perhaps more appropriate for a dissertation than for brief remarks. In addition, many would argue that we in the U.S. are still building a “more perfect union,” as we say in our Constitution, in the capital markets space. It is a work in progress. This is especially true in the aftermath of the 2008 financial crisis and the rapid transformation of technology and communications.

So, instead of offering lessons, I want to explore three concepts that I believe form the foundation for healthy capital markets, wherever they may be located. These concepts are transparency, competition, and resiliency.

The Public Good of Healthy Capital Markets – Getting Back on Track Since 2008

If the capital markets are a public good, like our highways or railways, then there are several elements critical to their efficiency and success: 1) the ability to see where one is going (transparency), 2) choices between a variety of options (competition), and 3) the ability to recuperate quickly if problems emerge (resiliency). Unfortunately, the last financial crisis was, in part, caused by opacity in our capital markets. This opacity arose from increasingly complex products, structures, and relationships, concentrations of risk in large financial institutions, and a lack of resiliency.

The story has been told before. Off-balance sheet vehicles, like securitizations, became increasingly complex with multi-tranche securitizations, re-securitizations of those

securitizations, and synthetic securitizations created from loans, bonds, and derivatives. Non-bank lending markets and investors appeared unattached to the banking system, and thus better able to absorb risks. However, fueled by advantageous capital treatment, many large financial institutions actually held large positions in these assets in their trading accounts. These financial institutions were part of the assembly line producing more and more of these products. They had a range of other exposures and guarantees linking institutions and markets together. Moreover, a web of opaque, over-the-counter derivatives exposures linked and concentrated risk in the largest financial firms. Unsurprisingly, markets underpriced the likelihood of these problems across the board. Unfortunately, we all know what happened.

So what have we done to strengthen our capital markets and ensure this does not happen again? What else should we be doing? I would argue we sought to go back – and, going forward, should keep going back – to those concepts I mentioned: enhancing transparency, boosting competitiveness, and strengthening resiliency.

Take, for example, the derivatives reforms set out in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). As some of you may know, before coming to the Commission, I served as staff in the United States Senate. In that capacity, I was deeply involved in the response to the 2008 financial crisis and especially the securities and derivatives aspects of the Dodd-Frank Act. I think I can sum up the approach that many of us took when drafting the bill, which was “never again.” Never again should we be faced with the complete lack of visibility into what was going on or what the possible consequences of our actions might be. Never again should so much risk and interconnectedness be concentrated in so few entities.

As a result, we focused on reporting and public dissemination of swaps transactions to both increase transparency and enhance competition; central clearing, margin, and capital to increase the resiliency of firms against unexpected losses; and open trading platforms to increase transparency and competition by bringing additional market forces to bear on pricing. All of these reforms are meant to protect against the collapse of one firm causing a domino effect. They also aim to boost competition by lessening the necessity for investors to trade only with the very largest financial institutions.

The Volcker Rule is another reform that seeks to strengthen resiliency and boost competition. It aims to strengthen banks’ resiliency by reducing their exposure to the ups and downs of the markets¹. And, it should enhance competition by enabling insurers, hedge funds, mutual funds, or others to trade and invest on a fairer and more level playing field. And it appears to be working. Last week, The Wall Street Journal noted what appears to be significant declines in value-at-risk positions at most of the major trading banks arising from significant declines in firms “commit[ing] tens of millions of dollars – or more – of their own money daily on trading hunches².” Not only is this making our core financial system safer, this is also a space where, as the Journal noted, investors can step in for opportunities.

The Dodd-Frank Act also made important changes to our securitization markets, with the aim to increase transparency, boost competition, and enhance resiliency. Loan-level detail is

now required across a wide range of asset classes, bringing new transparency to these markets. Mandating retention of risk by securitizers seeks to better align interests, hopefully increasing the resiliency. The legislation, and the Commission's subsequent rules, require ratings agencies to be supervised and held accountable for what they do, which should boost competition as well.

There is, however, more to do. In the area of securitization, section 621 of the Dodd-Frank Act mandates the Commission eliminate conflicts of interest by those that package securitizations. This section arose from an in-depth investigation led by colleagues in the United States Senate. But the SEC still needs to complete the regulation. I think we also have further to go in enhancing the transparency of waterfalls and improving the oversight of private offerings. More can be done to increase standardization of terms, conditions, and structures. We also must remain attentive to ensuring that securitization markets are actually transferring risk to those best able to hold it, and are doing so without concentrating risks and magnifying interconnectedness.

In offering these thoughts, do not misunderstand me about the value of capital markets financing. Corporations in the U.S. obtain tremendous benefit from the liquidity available to them in the corporate bond markets. And securitization has proven a reliable and successful tool for financing a number of asset classes, especially those amenable to greater predictability, like credit cards.

As Europe continues to implement important financial reforms, as well as considers how to expand the role of capital markets financing in its economy, I hope that the principles of transparency, competition, and resiliency are useful touchstones.

Digital Disruption: New Opportunities and New Risks

Even as we learn the lessons of the 2008 financial crisis, we cannot avoid the new challenges – and opportunities – that are arising daily. Technology is breaking down jurisdictional borders and altering old business models. Digital disruption and the new dominance of data are here to stay. And we in the financial regulatory community need to evolve.

On the plus side, digital disruption offers new opportunities for expanding the reach of capital markets. Crowdfunding is what I hear the most about. But up and down the continuum of capital formation, technology and communications are transforming how capital markets operate. Regulators must grasp this reality and encourage capital formation in ways that protect investors and enhance healthy competition. It may be too soon to say what ought to be done to regulate underwriting driven by computer algorithms, peer-to-peer lending based on social network credit analysis, or virtual currencies. But technology is dramatically upending old business models. We should all be thinking about what the right approach is to channel these new developments in a healthy and productive direction.

Frankly, we do not have a choice. Flash crashes, outages, glitches, and cybercrime underscore the need for strengthening our new marketplace infrastructure. Addressing these risks will be perhaps the defining challenge for regulators going forward. I would argue that the concepts of enhancing transparency, boosting competition, and strengthening resiliency

can serve us well in addressing this new world of data dominance too.

In this new era of disruptive technology and borderless business, cooperating across regulatory jurisdictions is more important than ever. The good work done in establishing the global Legal Entity Identifier is a great step forward but more needs to be done. In particular, I am committed to doing whatever I can to ensure regulators can access and share data. Just last week, the Commission advanced a new proposal for addressing the obstacle to international coordination created by the indemnification requirements of our laws³. The proposed rule would enable data sharing based on an international memorandum of understanding designed to protect the privacy of that data and ensure it is used for appropriate regulatory purposes only. It has not received much attention, but I am hopeful it is evidence of our commitment to making coordination work.

Additionally, I hope we can meet the new challenges that may come from the increasing awareness of the need for data privacy. Laws and regulations need to be designed in a way that preserves the ability of financial regulators to share information and coordinate internationally, while preserving important privacy protections. None of us want to face down another crisis like we did in 2008, largely blind to the implications of making one decision or another. We need to do everything we can to share and coordinate internationally.

Conclusion

Seven years since the financial crisis, we have made genuine progress. Yet, the work of strengthening our system is not done. All of us, in the U.S., Europe, and around the world, must redouble our efforts to fully implement the critical tools needed to boost transparency, competition, and resiliency. We must learn the lessons of the past crisis and think creatively to avoid having another one.

I know Europe has a keen interest in new ideas for ensuring healthy capital markets. I am pleased to be participating in this Eurofi conversation. More importantly, I look forward to hearing your thoughts. Thank you.

¹ I am pleased that the Commission has taken a leadership role in making the rule work. I look forward to us taking a thoughtful, step-by-step approach to examination and compliance that is well-coordinated with our peers in the banking agencies and transparent to market participants too.

² Justin Baer, James Sterngold, and Gregory Zuckerman, Large Banks Retreat From Trading Frenzy, *The Wall Street Journal*, Sept. 3, 2015.

³ See Access to Data Obtained by Security-Based Swap Data Repositories and Exemption from Indemnification Requirement, Release No. 34-75845, 80 FR 55181, Sept. 4, 2015.